Overview of Different Types of Trusts

Living Trusts

The living trust is very popular in America. A living trust helps you avoid the cost and delay of probate. You can also avoid the dangers from jointly owning assets. But a revocable living trust won't protect you from lawsuits.

Though a revocable trust won't protect you, you have the comfort of knowing that you can change or revoke your living trust as often as you can revise your will. But a living trust can cause you to lose lawsuit protection? Several states have ruled that a homesteaded home transferred to a living trust loses homestead protection. Similarly, assets owned between spouses as tenants-by-the-entirety may lose creditor protection from this type of co-ownership when those same assets are instead titled to a living trust.

There are trade-offs between the different ways to title assets. Without a revocable living trust, the court will distribute your assets under your will. This can be expensive, time-consuming, and cumbersome. (Probate costs can consume as much as 4% of an estate and delay estate distributions.) If you bequeath $1 million through your will, your heirs may pay $40,000 in probate costs, and wait years for their inheritances. A living trust circumvents the probate process. Your assets immediately transfer to your beneficiaries.

Have the best of both worlds. Title your assets to a limited partnership (to lawsuit-proof these assets). Have your living trust (which avoids probate) own your limited partnership. When you die, your ownership in the limited partnership immediately transfers through the living trust to your heirs, and avoids probate. During your lifetime your assets would be creditor-protected by the limited partnership.

Irrevocable Life Insurance Trusts

Life insurance is another important asset. Life insurance can have a substantial cash value or death benefit exposed to creditors. Even a term policy without cash value can be a valuable asset in that it will provide your family income and support after you are gone. But will your beneficiaries get the death benefit, or will your creditors? Life insurance can also pay your estate taxes and make funds immediately available to your survivors; thus avoiding the delay and expense of liquidating other assets.

If you own a large life insurance policy, title your insurance policy to an irrevocable life insurance trust (ILIT). An ILIT is specifically designed to own life insurance. As with other trusts, the ILIT has a trustee, beneficiaries, and terms for distributions.

Your ILIT would own your insurance policy. The insurance policy beneficiary would be the trust. When you die, your insurer pays the ILIT trustee, who would follow the trust instructions and distribute the proceeds to the ILIT beneficiaries. Your estate should not be the beneficiary.

An ILIT can be funded or unfunded. An unfunded ILIT's life insurance premiums are not fully paid. You fund future premiums (give annual premiums to the trustee, who pays the premiums). With a funded ILIT, you transfer to the trust a fully paid insurance policy or enough income-producing assets to pay the future premiums.

Whether you have an unfunded or funded ILIT, your policy premiums must be directly paid from the trust. You cannot directly pay the premiums or you'll lose both the trust's tax benefits and creditor protection.

The ILIT is irrevocable. It protects the policy's cash value, death proceeds, and distributions from the trust to the beneficiaries. If life insurance is not fully creditor-protected by your state laws, then an ILIT is essential for protection.

The ILIT - though sometimes important for protection - can save you estate taxes. Because the ILIT owns the life insurance policy, the policy proceeds won't be included in your taxable estate, nor subject to estate taxes.

Assume you are single and die with a $3 million estate and $1 million of that amount is life insurance. Assume that when you die you have a $2 million death tax exemption. Your estate would then pay an estate tax on $1 million. If the estate tax is 50 %, your estate tax would be $500,000. But your ILIT would remove the $1 million life insurance proceeds from your taxable estate. Your estate would save $500,000 in estate taxes because you reduced your taxable estate to zero.

The ILIT also gives you better control over policy distributions than insurance owned by you personally. When you personally own insurance, your insurance company directly pays the named beneficiaries when you die. An ILIT not only lets you control who receives the proceeds, but also how and when the policy proceeds will be distributed. For instance, you can specify that the ILIT trustee pays estate taxes and other costs (taxes due on IRAs or other retirement plans probate costs, legal fees, other debts, etc.) *before* the trustee distributes funds to the trust beneficiaries. Or you can direct your trustee to pay your beneficiaries over a period of months or years. You can add spendthrift, anti-alienation, discretionary distribution, and other protective provisions to protect the insurance proceeds from your beneficiaries' creditors. The ILIT can also avoid court interference if a beneficiary becomes incompetent. Insurance companies won't pay life insurance proceeds to an incapacitated beneficiary. They require court instructions. The ILIT avoids this unnecessary complication.

Children's Trusts

Do you intend to gift money to your children? Investigate an irrevocable children's trust (ICT). It can reduce taxes as well as provide protection. Property that you transfer to a children's trust cannot be seized by your creditors. It also won't be included in your taxable estate. Income from the trust would be taxed at the children's lower income tax rates. These are the reasons for the children's trust.

The ICT (or Section 2503 Minor's Trust) by its terms, controls the taxation and asset protection benefits of this trust. While the trust is in effect and the beneficiary is under 21, neither the grantors nor the child's creditors can claim the trust assets.

There is one disadvantage with the children's trust. When your child reaches 21, your child can demand the trust assets. Since it is an irrevocable trust, the grantor cannot withhold distributions from the trust. You cannot thus prevent your child from receiving the assets that are then owned by the trust. You can only extend the trust until a later age if your child, at age 21, consents in writing. Carefully consider whether your child (ren) at that young age can properly handle the trust assets.

Charitable Remainder Trusts

Gifting your assets to charity may seem an extreme way to gain creditor-protection, however, our tax laws allow you to give away your property to charity, achieve protection, and use these same assets to generate income for you during your lifetime. For protection, as well as the tax advantages from gifting assets during your lifetime, the Charitable Remainder Trust (CRT) can be your answer.

Here's an overview of how the CRT works. As the grantor, you select a tax-exempt charity as the beneficiary of your irrevocable trust. When you create and fund the CRT, you make a charitable donation and can claim an immediate tax deduction for the value of the assets contributed to the trust. Although you have gifted the principal, you would be the income beneficiary. Over your lifetime, your trust would pay you a fixed annual income. You thus get an immediate tax deduction and future income from the donated assets.

Assume that you have $200,000 in stocks that were purchased 15 years ago for $60,000. If you sold the stock to invest in treasury bonds, you would pay $21,000 in capital gains taxes on the profit (15% X $140,000 gain). If your treasury bonds are worth $200,000 when you die, your estate may then pay another $88,000 in estate taxes (although future estate taxes are uncertain). Your heirs would inherit, after taxes, only $91,000 from the original $200,000.

So, you don't sell your stocks. Instead you transfer them to a CRT. You get the same annual income as from treasury bonds for the remainder of your life because you could be the CRT's income beneficiary. You deduct your $200,000 donation as an immediate charitable contribution. The income from the tax savings from your charitable deduction can buy a $91,000 life insurance policy to cover the $91,000 that your beneficiaries would have received had you donated your stock to the CRT. The net result: a large tax deduction this year, the same perpetual fixed retirement income as with treasury bonds, you donate to your favorite charity, and the donated trust assets are lawsuit-proof.

Do you have appreciated assets? Do you want a fixed lifetime income? Would the CRT's fixed income satisfy your retirement needs (adjusted for inflation)? If so, a CRT may be a good protective strategy for you - particularly if it can help you achieve your philanthropic goals. Income from the CRT can be seized by your creditors, but even then there are solutions. For example, your income can be protected through a charitable remainder annuity trust (CRAT), if your state exempts annuities from creditor seizure. Other trusts are variations on this theme.

Qualified Personal Residence Trusts

With a Qualified Personal Residence Trust (QPRT, you transfer your residence to the trust and retain a tenancy for ten years. At the end of the term, your residence passes to your beneficiaries. Your objective is to transfer your residence now at its lower value (basis), rather than when you die and it has a greater value. The QPRT thus reduces estate taxes.

A QPRT can also lawsuit-protect your home. Your creditors can only claim your right to use the property for the remaining term of years (or the rental value for those years). However, your creditor cannot attach or seize the home because it would be owned by the trust. The beneficial remainder interest can be claimed by your beneficiaries' creditors, unless your trust includes those important spendthrift provisions. At the end of the term, the trustee must distribute or convert the QPRT assets into an annuity. This is a more desirable alternative in states that creditor-protect annuities.

If you are in a second (or third, fourth, or fifth marriage), the Q-TIP (Qualified Terminable Interest Property) trust may interest you. The Q-TIP ensures that your spouse will receive a lifetime income from the trust. The trust principal then passes to your children (or alternative beneficiary) after your spouse dies or remarries.

Q-TIPs are common with second marriages because they preserve your assets for the benefit of the children from a prior marriage, rather than the spouse's children or family, who would become the probable beneficiaries of an estate bequeathed outright to a surviving spouse. Q-TIPs can also protect a spouse when the grantor believes that the spouse may waste the assets during the spouse's lifetime. A Q-TIP is essentially a spendthrift trust to shelter your assets from your spouse's creditors or subsequent mates.

Income from the Q-TIP trust must be used solely to benefit the surviving spouse during the spouse's lifetime, or the trust won't qualify for the unlimited marital deduction. Estate taxes on the principal are deferred until the surviving spouse dies.

A Q-TIP trust won't protect your assets against your creditors, because the Q-TIP is a testamentary trust. However, a Q-TIP trust can shelter your wealth from a spendthrift spouse, a spouse who may have future financial or legal difficulties, or a spouse who may wish to leave *your* money to *his or her* children.

The Q-TIP's trust principal will be safe from your spouse's creditors, though the income to your spouse would not be protected. Moreover, the trust income must be distributed as earned. The trustee cannot withhold distributions.

You can use a similar irrevocable intervivos marital deduction trust for protection. The objective is to shift marital assets from the higher-risk spouse to the less-at-risk spouse. This is only another form of lifetime gifting. These transfers are also subject to fraudulent transfer claims. A spouse who makes an outright gift must understand that the transferred assets may be lost by a surviving spouse in a later lawsuit or in divorce. It can also be lost to the spouse's spendthrift spending.

Land Trusts

Land trusts, widely used in Illinois, Florida, Georgia, California, Colorado, and a few other states can partially insulate real estate against lawsuits. The land trust can own any real estate - including the family residence. A bank is normally the trustee. The land trust protects the beneficiaries' interest in the real estate only if the trust has the proper spendthrift and anti-alienation provisions. As the trust beneficiary, you don't directly own the real estate. The real estate is titled to the trustee. You own only a beneficial interest in the trust. This interest is personal property, not real property.

Owning a beneficial interest in a land trust is not sufficiently protective. Your creditors can seize your beneficial interest. You need more protection. One option is to title your beneficial interest to a limited partnership, LLC or to an irrevocable trust.

Land trusts have two disadvantages. It is frequently difficult to finance land trust property as it's necessary to temporarily re-convey the property out of the trust to its grantors or beneficiaries to complete the financing. Also, a beneficiary desiring a Section 1031 tax-free, like-kind exchange, must transfer the property from the trust, since a land trust is not a beneficial interest in real property but an interest in personal property.

Privacy, not asset protection, is the land trust's major advantage. The beneficial owners won't appear on the public records because the property is titled to the trustee. To the extent secrecy aids protection, the land trust can be helpful.

Medicaid Trusts

Nursing home costs can impoverish you as quickly as a lawsuit. Hence, the Medicaid trust. This special purpose trust shelters assets so the grantor can qualify for Medicaid to pay their nursing home costs. Medicaid trusts, of course, chiefly interest those who prefer to leave their money to their children rather than spend it on their own long-term care.

A Medicaid trust is similar to other irrevocable trusts. The grantor (as an individual or couple) transfers their assets to an irrevocable trust. However, unlike other irrevocable trusts, the grantor can be the income beneficiary. Their children or spouse would be the residual beneficiaries. The grantor can receive income from the trust to the maximum amount allowed by Medicaid. But the now, asset-free grantor can qualify for Medicaid nursing home assistance.

The Medicaid trust offers about the same asset protection as any other irrevocable trust. Medicaid trusts prohibit using the trust assets for other health care purposes, and it also limits the beneficiaries' income to those income limits set by Medicaid. You must create and fund your Medicaid trust 60 months before you apply for Medicaid. That's its one disadvantage: Few people can anticipate their long-term care needs that far in advance.